The New View on Fiscal Policy and its implications for the European Monetary Union

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WIFO

The New View on Fiscal Policy and the Future of the European Monetary Union

- **Aim of this paper**
- **Extend with theoretical and empirical evidence the New View on Fiscal Policy, as presented by Furman (2016)**
- **Discuss optimal fiscal policy at the ZLB**
- **Identify recent developments in the fiscal policy literature that have wide-reaching policy outcomes**
- **Derive practical implications for the future of the European Monetary Union and for current EMU reform proposals**

The New View and the Future of the European Monetary Union

- A rethinking of the optimal policy mix between monetary and fiscal policy in a recession; summarized last year by Furman (2016)
- **Importance to focus fiscal policy not only on long-term public finances sustainability, but also on short-term business stabilization**
- Fiscal policy is a very important complement to monetary policy, **especially at the zero lower bound**
- Aim of this paper - assess empirical evidence and theoretical work on the New View on fiscal policy
- But also explore the implications of New View for the future of the European Monetary Union economic architecture

The New View

- *„And today, the G-20 is no longer debating growth versus austerity, but rather how to best employ fiscal policy to support our economies, and increasingly how to make sure the benefits of growth are more widely shared, while continuing to focus on sustainable long term fiscal policies."*

  - Jack Lew, August 2016

- *„The academic consensus on austerity solidifies, but policymakers go their own sweet way."*

  - Simon Wren Lewis, February 2017

The New View

- *„Fiscal rules are non-transparent, pro-cyclical, and divisive, and have not been very effective in reducing public debts. The flaws in the euro area's fiscal architecture have overburdened the ECB and increasingly given rise to political tensions"*

  - Benassy-Quere et. al, January 2018, *How to reconcile risk sharing and market discipline in the euro area*

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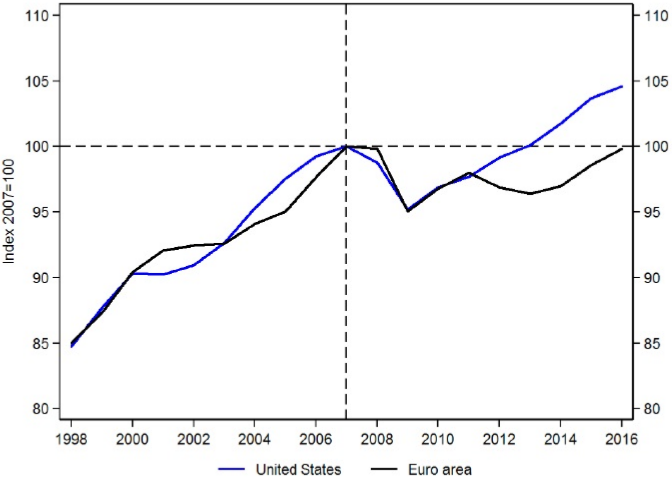
Economic performance across the US and the EU (GDP level, 2007 = 100) - the Eurozone malaise



Notes: Annual real GDP per person. IMF WEO, April 2017. Euro area reflects EA12 aggregate.

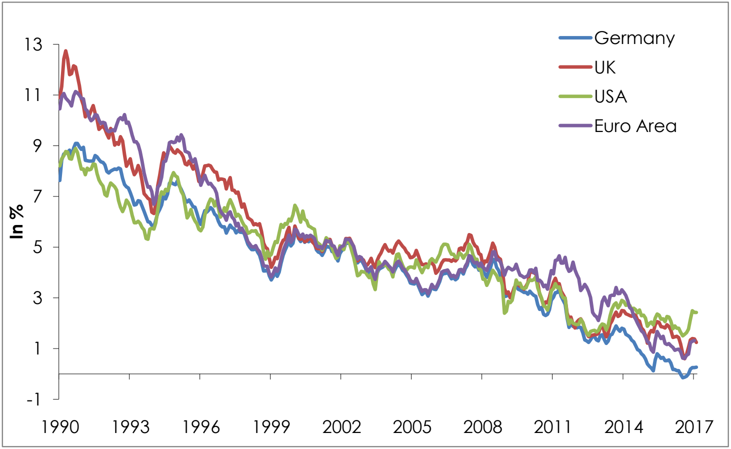
Background

- How to assess the lagging and suboptimal economic performance of the Eurozone in comparison to the US experience (and the Asian experience of the 90s)
- Many commentators see the main reason for this in the insufficient support from fiscal policy to help monetary policy overcome the recession
- Recent seminal contributions - Blanchard & Summers (2017), Alan Auerbach Jackson Hole Speech (2017), Auerbach (2017)
- But there are other important viewpoints that explain the macroeconomic divergence with supply side weaknesses of the Eurozone (Breuss 2017, WIFO WP No. 541)
- This makes it important to understand the New View and whether it can explain possible past policy mistakes in the Eurozone
- Auerbach (2017) points to a *„a declining excitement about the possibility of expansionary fiscal contractions“*

Background

- Not only ex-post analysis of the recent Eurozone malaise - but also policy implications for the future
- The New View on fiscal policy is also important due to the downward trends in observed long-term interest rates (Figure 4)
- As well as estimations of long-term interest rates as in Laubach and Williams (2015; 2017)
- Both point to a lower equilibrium interest rates for the foreseeable future
- Meaning less space for monetary policy & monetary policy more often at the ZLB
- more often it will be efficient to use fiscal policy
- More space for fiscal policy (especially when $r < g$)
- Blanchard and Summers (2017) even assume $r < g$: „*Cannot be sure it will be forever, but r can be locked in: 0.9 % for 30-year. Very likely to be less than average g.* “ (Blanchard and Summers 2017 examples revolve around US)

Trends of long-term interest rates - Government bond yields - 10 Years



S: OeNB.

The New View

The New View on fiscal policy thus makes the case for the overall benefits of running fiscally activist policy in a deep recession. What are the mechanisms behind this view?

1. Effectiveness at the ZLB/effectiveness overall (structural characteristic)
2. Multipliers during the recession (empirical estimates)
3. Fiscal space is higher than assumed when properly accounted for stimulus effects
4. Spillovers are significant (especially in a monetary union)
5. Sustained stimulus might be preferable to short-term discretionary spending
6. Addendum: Effects of heterogeneity of agents and distributional developments on fiscal policy as a stabilisation tool

Fiscal policy supports monetary policy at the ZLB

- Fiscal policy can be a significant and efficient complement to monetary policy especially at the ZLB
  - Fiscal stimulus affects output through **the GDP identity**, but most importantly - **through the expectations channels**
  - Keynesian effects

$$Y = C + G + I$$

  - New Keynesian effects

$$r_t^f = i_t - E(\pi_{t+1}) + \epsilon_t$$

  - Instead of crowding-out, at the ZLB there are **crowding-in effects**
  - Werning 2011, Eggertson 2013, Woodford 2012 , Erceg and Linde 2014
  - New Keynesian DSGE macro finds mostly high stimulative effects through influencing the inter-temporal decision
  - Harsh criticism on dependence of results from the choice of equilibrium - Cochrane, JME December 2017

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  - But also due to the Fiscal theory of the prive level (FTPL) a la Leeper (1991) and Sims (2016)
  - In the current setting the FTPL says that if you do **monetary accommodation, combined with government consolidation efforts, this will be self-defeating** - the consolidation of the government balance sheet (that is assumed by current models as irrelevant for inflation) will reduce inflationary pressures and the CB cannot hit its target
  - Sims (2016) implied in his Jackson Hole speech (2016) that the government should actually commit to higher inflation in the future - this influences the intertemporal decision of agents (making them „less Ricardian“)
  - Bianchi and Melosi (2017) implement the proposal by Sims (2016) and show that coordination between monetary and fiscal policy is indeed crucial

The fiscal multiplier debate

- „From a theoretical perspective, there is no such thing as **the multiplier**“ Corsetti, Meier & Mueller (2012)
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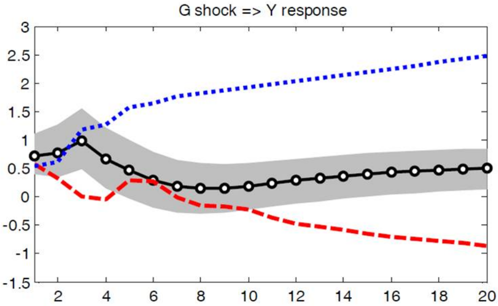
Auerbach and Gorodnichenko (2012) - Measuring the output responses to fiscal policy

- Discretionary fiscal stimulus can be very effective - evidence from a Markov-switching model (Auerbach and Gorodnichenko (2012))
- Impulse responses in the linear model, expansions and recessions - Government spending multiplier of 2.2



The figure shows impulse response to a USD 1 % increase in government spending on GDP. Dashed lines show the responses in expansionary (red, long dash) and recessionary (blue, short dash) regimes. The solid line with circles shows the response in the linear model.

Empirical studies of the multiplier

- Similarly, New Keynesian DSGE model estimations also find high multipliers from government stimulus at the zero-lower bound
- A team of IMF, ECB, European Commission and academic economists did a large estimation on the size of fiscal multipliers in structural models (Coenen, Erceg et. al 2012 - Effects of Fiscal Stimulus in Structural Models, AEJ: Macro Jan 2012)
- Used seven well known macromodels that are in use in international organizations (QUEST, GIMF, FRB-US, SIGMA, BoC-GEM, NAWM, OECD Fiscal) to find some common conclusions of the effectiveness of different types of temporary (and permanent) fiscal measures
- **They find that the most efficient temporary fiscal stimulus comes in the form of spending or well-targeted transfers and is especially powerful when monetary policy is accommodative (maximum multipliers of around 2.2)**

Fiscal space is higher than perceived

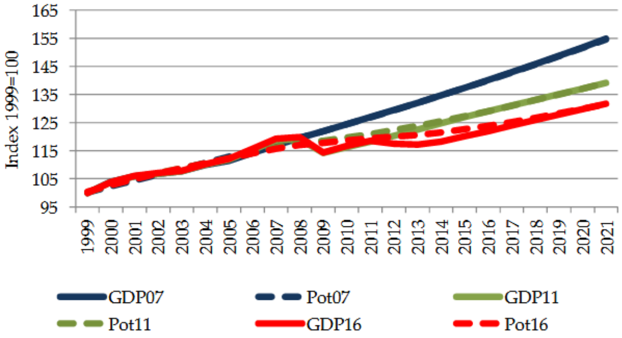
- Discretionary fiscal stimulus at the ZLB can pay for itself - so even if it burdens public finances currently, it leads to **a reduction of debt-to-GDP** in the long run for most realistic cases - so should not be seen as irresponsible
- Summers and DeLong 2012 - seminal paper in that direction
- Auerbach and Gorodnichenko 2017, Jackson Hole - use their regime switching VAR framework to point to the fact that fiscal expenditure shocks do not on average lead to fiscal sustainability problems

Summers and DeLong 2012 - Some pleasant fiscal arithmetic

- Channels through which a fiscal stimulus can pay for itself in a recession:
  - High fiscal multipliers
  - Important hysteresis effects on potential output through underinvestment and through labour market hysteresis
  - Through stimulus, one could have higher potential output in the future and thus reduce debt-to-GDP ratios through the effects on GDP
  - The stimulus has both a positive and negative effect on budget balances - it costs something, but it also brings additional revenues from higher economic activity
  - Does not mean we can do stimulus all the time - because the multiplier gets smaller in normal times

Fiscal space is higher than perceived - importance of hysteresis effects

- Hysteresis during the Great Recession had important negative effects on potential output, which was consistently revised downwards



Significant spillover effects in a monetary union

- Spillover effects are much higher if we are in a world of inadequate aggregate demand (like in Eggertson 2016 - secular stagnation)
  - In't Veld (2013) shows the importance of the spillover effects using QUEST
  - Blanchard, Leigh and Erceg (2015):
  - Use a standard medium scale DSGE open economy model (Gali & Monacelli)
  - Find crucial spillovers effects from government stimulus in the core (e.g. Germany) to the periphery (e.g. Italy)
  - Crucial is the correct calibration of the import shares in the core country from the periphery, also in terms of government purchases to be imported
  - Plus the importance of hand-to-mouth consumers in the periphery (they spend their additional income coming from exports to the core)
  - **Policy implications: because of the large spillover effects, a policymaker in the core that wants to maximize euro area welfare should increase fiscal spending double as much as if only focus was on own country welfare**

Sustained stimulus rather than a short lived one

- Sustained stimulus rather than a short lived one
    - Use near zero interest rates to commit to long-term infrastructure projects, which can enhance productivity and long-term potential output
    - Werning 2011 shows that this holds in the DSGE world - in this type of model committing to expansion for longer influences expectations for longer
    - Cochrane (2017) critique on multiple equilibria and why this is not plausible
    - Werning 2011 actually does not imply the stimulus can be longer than the liquidity trap
    - But Furman (2016) implies there are important benefits of commiting the government stimulus to important infrastructure projects, rather than to just do short-term output stabilization spending (Keynesian "hole-digging")

Addendum: Hand-to-mouth consumers, inequality and fiscal policy

- The importance of hand-to-mouth consumers to properly assess fiscal policy affects
- Representative agent models do not take into account full effects
- Rule-of-thumb consumers are not Ricardian (Gali, Lopez-Salido and Valles 2007)
- Recent evidence from Kaplan and Violante (2015) on „rich hand-to-mouth consumers“
- HANK (Heterogenous Agents New Keynesian model) very important to follow dynamics, especially given the changes in distribution of income and wealth in the past decades (Auclert and Rognlie 2016)
- More inequality thus means that stimulative fiscal policies are more effective - explains changes in efficiency

The New View and its channels - an overview

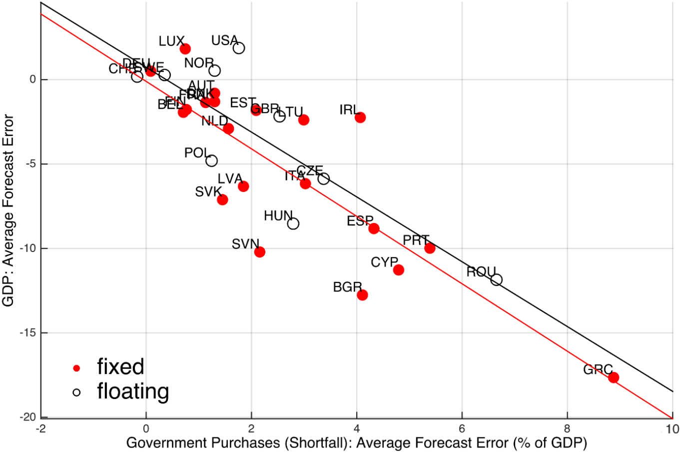
	Explanation	Seminal papers
At the ZLB, there are important complementarities between monetary and fiscal policy	(Structural) effects at the liquidity trap through the expectations channel	Werning 2011, Coenen et. al 2011, Blanchard, Linde and Erceg 2015, Sims 2016
Discretionary fiscal policy can be very efficient - high multiplicators in a recession	Empirical state-dependent SVAR models (which better address non-linearities) show that multiplicators might differ significantly between an expansion and a recession	Auerbach and Gorodnichenko 2012, Castelnuovo et. al 2014
Fiscal space is higher than perceived	Static debt sustainability analysis ignores important effects of stimulus	Summers and De Long 2012, Auerbach and Gorodnichenko 2017
Important Spillover Effects	An aggregate demand stimulus affects not only the country in question but also its trading partners, especially during a recession	Blanchard, Erceg and Linde 2015, IMF 2016
Sustained rather than short-term stimulus	Long-term investment enhances potential output	Werning 2011, IMF 2016

The costs of fiscal consolidation

- A number of studies, starting from Blanchard and Leigh (2013), point that a fiscal activist approach (the New View) would have been welfare enhancing for the Eurozone in the 2011 - 2015 period
- Blanchard & Leigh (2013) pointed to the negative correlation between fiscal consolidation efforts and forecasting errors of GDP (a purely statistical perspective)
- Blanchard, Linde and Erceg (BLE) (2015) put this into a DSGE framework and stimulate the fiscal multipliers as well as spillovers (which are large)
- House, Tesar & Proebsting (2017) use a medium scaled DSGE model (based on BLE 2015) of 29 countries to do a counterfactual experiment
- The model manages to replicate the negative relationship observed in the data between austerity and downward growth revisions
- Austerity is defined as government spending reductions in excess of what a reduced form, in-sample forecast would have predicted (similar to the Blanchard and Leigh (2013) definition)
- As they manage to replicate the observed relationship between austerity and growth forecast errors, they also run a counter-factual analysis to see the outcomes if no excessive government spending reductions were implemented

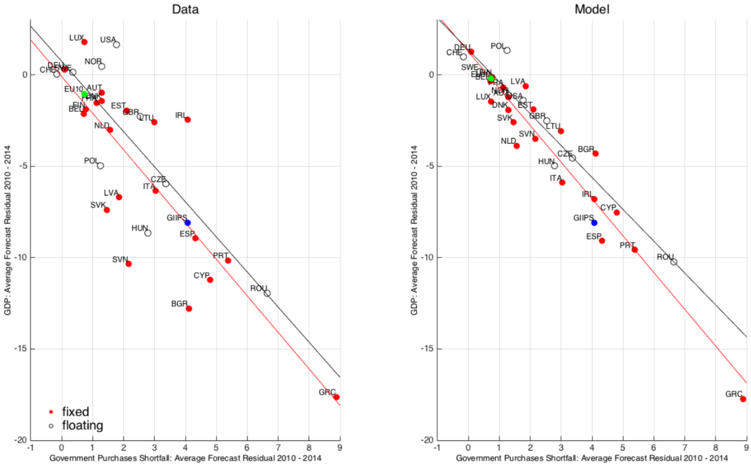
The costs of fiscal consolidation

- House, Tesar & Proebsting (2017) empirics - negative correlation between excessive government cuts and downward growth revisions



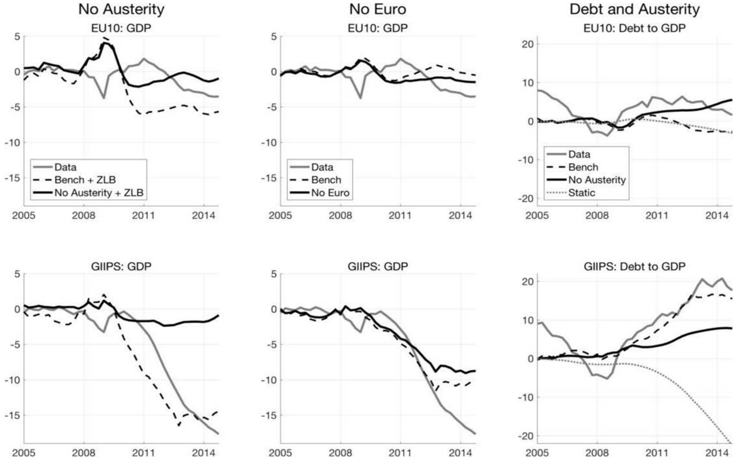
The costs of fiscal consolidation

- House, Tesar & Proebsting (2017) model replicates the data



The costs of fiscal consolidation

- House, Tesar & Proebsting (2017) counterfactual policy simulation - no austerity cases (black line in first column) improves economic outcomes significantly for both core and GIIPS - in GIIPS countries instead of output reduction of 18 % below trend, output losses would have been only 1 %.



EU Implications

- The EMU setup is incomplete - **no mechanism to address asymmetric shocks, no Euro area fiscal stabilization function, rules are asymmetric**
- A window of opportunity to complete the setup
- Independent national fiscal policy coordinated by rules (currently) versus common fiscal policy/fiscal stabilisation function
  - The rules are not in line with the New View - amend the rules or build new institutions (forfeit the rules)
  - Middle way options - at least build common automatic stabilizers
  - Move towards a common Eurozone fiscal stance via a common fiscal institution - Tabellini (2016) - European Fiscal Institute
  - Benassy-Quere (2016) - a common European Fiscal Stance only in „exceptional times" - plus amend the rules so the fiscal stance is governed not only by the output gap, but by the current account
  - „We want to ensure appropriate policy stimulus happens when needed and in effective manner" (Shambaugh 2017)

EU Implications

- But also funding question for a future Eurozone fiscal capacity is crucial
  - The debate on European safe assets
    - Risk sharing versus no risk-sharing arrangement (pooling vs tranching and pooling a la Brunnermeier's ESBies 2016)
  - Brunnermeier's (2016) „Battle of the Ideas“ crucial for understanding the dividing lines:
    - German tradition of federalism implies hard rules and market discipline
    - French tradition of absolutism and central power implies common institutions and discretion
  - Debate not only between rules versus discretion and sovereign versus central institutional arrangement, but also between more cooperation versus market discipline
  - This debate is at the center of the future of the EMU set-up, but should be led by the evidence pointing to the New View

EU Implications

- **Orphanides 2017 - The Fiscal-Monetary Policy Mix in the Euro Area:** Challenges at the Zero Lower Bound; European Commission Fellowship Initiative Discussion Paper 60:
  „These paths towards escaping the current malaise involve either changes in the Treaties, which presupposes unanimous support by all EU member states, or the voluntary consent by the governments of all euro area member states. Neither of these conditions is likely to be met .... The reason is simple. Although the current dysfunction has harmed the euro area overall, the distributional effects have been uneven. While most member states have suffered, a few member states have benefited from the crisis and continue to benefit from the persistent fragility. **In this light, the political feasibility constraints required for advances that require unanimous support cannot be met.** Member state governments that have been experiencing short-term benefits from the status quo do not have an incentive to accept changes that would be against their short-term interest"

Two paradoxes

- Paradox of austerity - politicians and policymakers that have normally been assumed as too lax on fiscal sustainability, have been during the Great Recession in the Eurozone more tight on fiscal policy, while scholars and academics have agreed that a more positive fiscal stance would have been suitable
- Paradox of the Eurozone fiscal policy arrangement - countries that want to do more cannot, while countries that can do more, don't want to (Buti 2017)

Conclusions

- Macroeconomic theoretical evidence from a New Keynesian tradition, as well as empirical studies, move towards a new Consensus Agreement on the need for fiscal activism during a recession
- However, the European Monetary Union institutional set-up does not fit this New Consensus
- Take seriously the long term benefits of exiting recessionary periods and avoiding hysteresis effects on potential output
- The complexity of the problem is reinforced by the political problem behind it - a double constraint for an optimal decision
- Amending the current EMU setup will support the long-term economic development of the EU and will make it more crisis-resistant
- What would be the optimal change?
- What would be the politically feasible change? Search for incentives to motivate countries to agree

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